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IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

ROBERT A. BROOKS AND CAROL M. BROOKS,
Petitioners,

v.

THE UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

After pretrial rulings on questions of law, the district court defined the sole issue of fact remaining for trial to be whether Chief Judge Wesley E. Brown, in an earlier action filed by the Securities and Exchange Commission, had approved Clinton Oil Company's 1974 Stock Option Plan. After hearing live testimony at trial and considering the deposition of Judge Brown, the district court found that Judge Brown had approved the stock option plan. On appeal, the Tenth Circuit reversed, stating that the district court's finding was clearly erroneous.

The question presented is:

Whether the court of appeals failed to apply the clearly erroneous standard of review to the narrow factual issue presented, as required by *Anderson v. Bessemer City*, 470 U.S. 564 (1985), and instead, improperly substituted its own fact-finding for that of the district court by revising and restating, *sua sponte*, the issue of fact to be decided.

LIST OF PARTIES

The parties to the proceedings below were the petitioners, Robert A. Brooks and Carol M. Brooks, and the respondent, United States of America.

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IN THE SUPREME COURT
OF THE UNITED STATES

October Term, 1994

ROBERT A. BROOKS and CAROL M. BROOKS,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The petitioners Robert A. Brooks and Carol M. Brooks respectfully pray that a writ of certiorari issue to review the order and judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above-entitled proceeding on August 3, 1994.

OPINIONS BELOW

The order and judgment of the Court of Appeals for the Tenth Circuit was entered without a published opinion, 30 F.3d 141 (Table), and is reprinted in the appendix hereto, p. 1a, *infra*.

The decision and judgment of the United States District Court for the District of Kansas (Theis, D.J.) was reported at 797 F.Supp. 909, and is reprinted in the appendix hereto, p. 15a, *infra*.

Two earlier opinions of the United States District Court for the District of Kansas were reported at 779 F.Supp. 512 and 766 F.Supp. 993, and are also reprinted in the appendix hereto, *infra*, at pp. 29a & 36a.

JURISDICTION

Invoking federal jurisdiction under 28 U.S.C. § 1346(a)(1), the petitioners brought this action in the United States District Court for the District of Kansas for refund of federal income taxes paid for the 1980 tax year. On June 22, 1993, the District Court (Theis, D.J.) entered judgment in favor of the petitioners. App. at 15a.

On respondent's appeal, the United States Court of Appeals for the Tenth Circuit entered an order and judgment reversing the District Court for the District of Kansas. App. at 1a. A petition for rehearing and suggestion of rehearing *en banc* was timely filed by the petitioners, and an order denying rehearing was entered by the Tenth Circuit on October 3, 1994. App. at 51a.

The jurisdiction of this Court to review the judgment of the Tenth Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Section 422(b)(1), Internal Revenue Code of 1954[1], 26 U.S.C. § 422(b)(1).

(b) Qualified stock option.--For purposes of this part, the term "qualified stock option" means an option granted to an individual after December 31, 1963 (other than a restricted stock option granted pursuant to a contract described in section 424(c)(3)(A)), and before May 21, 1976 (or, if it meets the requirements of subsection (c)(7), granted to an individual after May 20, 1976), for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if --

> (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted . . . .

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[1] Section 422 which governed "qualified stock options" during the time relevant to this action, was added to the Internal Revenue Code of 1954 in 1964 by Pub. L. No. 88-272, 78 Stat. 64. It was repealed in 1990 by Pub. L. 101-508, 104 Stat. 1388-521, and was replaced by the current § 422 (formerly § 422A) which was added in 1981 by Pub. L. No. 97-34, 95 Stat. 256, and which governs "incentive stock options."

STATEMENT OF THE CASE

Many of the facts in this case were the subject of stipulations in the pretrial order, and were based upon court pleadings in the case of *Securities and Exchange Commission v. Clinton Oil Company, et.al.*, Civil Action No. W-5020 (W-5020), U.S. District Court, District of Kansas. Most of the material facts are not in dispute, and were incorporated in the trial court's orders and decisions.

In January 1973, the Securities and Exchange Commission (SEC) filed W-5020 claiming that Clinton Oil Company (Clinton) had violated federal securities laws, and seeking, *inter alia*, the appointment of a receiver. The case was assigned to then Chief Judge Wesley E. Brown. The appointment of a receiver would have automatically terminated valuable foreign oil and gas leases owned by Clinton in the North Sea. Counsel for both the SEC and Clinton wished to avoid such a drastic consequence, and they urged Judge Brown to undertake a unique and innovative type of judicial supervision over Clinton's operations.

In accordance with the terms of a written settlement agreement, Judge Brown entered an order of March 8, 1973 in W-5020, whereby he assumed extraordinary authority and control over Clinton. Judge Brown was authorized to designate a president and chief executive officer for Clinton, to appoint a certified public accounting firm and special counsel to review past actions of Clinton, and to approve, with the SEC's consent, new directors for Clinton. The order also provided that Judge

Brown would retain jurisdiction over the implementation and enforcement of the settlement.

The lead attorney for the SEC in W-5020 testified at trial that the intent and purpose behind the settlement was to have a federal judge act as a receiver instead of having a federal judge appoint a receiver. He further testified that under the terms of the settlement, Judge Brown stood in place of Clinton's stockholders and exercised all managerial powers for Clinton.

Judge Brown performed these extraordinary responsibilities from March 1973 through July 1976, and during that time period no stockholder meetings were held.[2] In 1973, he appointed a new CEO and negotiated an employment contract with the CEO which granted him stock options and contemplated additional stock option plans in the future. He also appointed new directors, special counsel and an auditing firm in 1973.

In exercising his control over Clinton, Judge Brown acted only after being advised of the positions of all parties, including the SEC, and after thoroughly reviewing any necessary and appropriate written documents. Judge Brown paid attention to written documents he was given, and did not merely "rubberstamp" proposals from the company's attorneys or officers. This was evidenced by the fact that when he approved the employment contract for the new CEO in 1973, he forcefully rejected a request

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[2] In 1973, a stockholder protective committee moved to intervene in W-5020, and asked Judge Brown to direct Clinton to convene a meeting of its stockholders. The committee also asked for permission to inspect Clinton's stock ledger, which Judge Brown denied. No stockholder meeting was ordered or held. App. at 39a.

by Clinton's directors that they also receive stock options.

On March 18, 1974, Clinton's directors approved several employee plans, including the Clinton Oil Company 1974 Stock Option Plan (Plan). The Plan contained a normal and usual boilerplate provision concerning approval by Clinton's stockholders:

> This Plan . . . shall be subject to approval by the stockholders of the Company within twelve (12) months after March 18, 1974; however, the disapproval by the shareholders of this Plan or the failure of the shareholders to vote on this Plan shall in no way affect the Plan other than the Plan's qualifications for Internal Revenue purposes.

On March 20, 1974, the Plan was presented to Judge Brown during an informal meeting in his chambers, attended by Clinton's attorney in W-5020, Clinton's Chairman of the Board, and Clinton's CEO. Judge Brown was given a copy of the Plan, and the undisputed testimony at trial was that he orally approved the Plan.

The petitioner, Robert A. Brooks, was employed by Clinton in 1977,[3] and was issued stock options under the 1974 Plan. When the petitioner exercised those options in 1980, the fair market value of the stock exceeded the exercise price of the options. The difference was treated by the Internal Revenue Service as a gain. For the tax year 1980, the petitioners paid additional taxes

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[3] After 1974, Clinton changed its name to Energy Reserves Group, Inc.

of $210,253 which were directly attributable to the gain on the exercise of the stock options. App. at 41a-42a.

The petitioners filed this action in the District of Kansas seeking refund of the additional federal income taxes attributable to the exercise of the stock options under the Plan. Both the petitioners and the respondent filed motions for summary judgment on the legal issue of whether Judge Brown had the authority to approve the Plan under § 422(b)(1) on behalf of Clinton's stockholders.

Noting that Judge Brown had exercised extraordinary powers in conducting Clinton's business, powers normally reserved to a corporation's directors and stockholders, the district court concluded that when Judge Brown exercised authority normally reserved to stockholders, he acted as the unanimous voice of the stockholders. App. at 46a-47a. Therefore, the district court concluded that Judge Brown had the authority to approve the Plan on behalf of Clinton's stockholders under the Internal Revenue Code. However, because Judge Brown had not issued a written order approving the Plan, and because there was no transcript of a proceeding where Judge Brown approved the Plan, the district court held that the petitioners had not met their burden of proving that Judge Brown did, in fact, approve the Plan. App. at 50a. The district court noted that there was no deposition or affidavit from Judge Brown in the record, and summary judgment was granted for respondent.

Petitioners filed a motion seeking to alter or amend the judgment, and requesting permission to take the deposition of Judge Brown. After Judge Brown's deposition was taken and included in the record, the

district court reconsidered its prior summary judgment ruling. The district court stated that it was convinced from a reading of Judge Brown's deposition as a whole and other corroborating evidence, that a fact question was presented as to whether Judge Brown approved the Plan. The summary judgment in favor of respondent was set aside, App. at 34a-35a, and the case was set for trial.

On June 15, 1992, the case was tried to the district court sitting without a jury. The petitioners presented the oral testimony of Clinton's attorney in W-5020, Clinton's CEO, and the SEC attorney in W-5020. Judge Brown's deposition was admitted into evidence. The respondent presented the oral testimony of petitioner Robert A. Brooks. The district court subsequently issued its decision dated June 22, 1992, and entered judgment in favor of the petitioners. App. at 15a.

In its opinion, the district court first noted the factual issue being tried[4] (App at 16a):

> The narrow factual issue remaining for trial was whether the Honorable Wesley E. Brown, United States District Judge, approved the 1974 stock option plan of Clinton Oil Company ("Clinton") (now known as Energy Reserves Group, Inc.).

The district court then made the following factual findings (App at 22a, 24a-25a):

> 27. At a meeting with Judge Brown in

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[4] This narrow issue of fact is also the sole issue of fact identified in the Pretrial Conference Order.

chambers on March 20, 1974, Judge Brown orally approved a benefits package for Clinton employees, including the 1974 stock option plan at issue here.

* * *

38. The court found all the witnesses to be credible. The court found especially credible SEC attorney Hewitt, who was the lead attorney in *SEC v. Clinton* and is an uninterested witness. The court found the testimony of Volk [Clinton's CEO] to be credible, notwithstanding his pending tax refund claim which involves the same legal and factual issues as the present case.

39. The witnesses--both interested and disinterested--recounted the same basic facts. The testimony of the other witnesses corroborated Judge Brown's recollection that he may have orally approved the stock option plan. Other corroborative evidence includes the employment contract between Clinton and Volk which included a stock option, which was approved by Judge Brown in a formal written order. The Volk employment agreement anticipated future stock option plans. Plaintiffs' Exh. A, Tab 19. The stock option plan at issue here provides the stock options for certain employees, with no stock option provision for directors. Plaintiffs' Exh. C. This is in conformity with Judge Brown's distinct recollection of his disapproval of the stock

option for directors.

* * *

41. The stock option proposal was presented to Judge Brown in an informal meeting in chambers. Judge Brown orally approved of the employee stock option plan, agreeing that it was an appropriate means to recruit new talent to Clinton.

42. Judge Brown, acting as the unanimous voice of the Clinton stockholders, orally approved the 1974 employee stock option plan.

The district court concluded that the option exercised by the petitioners was a "qualified stock option" under § 422 of the Internal Revenue Code of 1954. Judgment was entered granting the Petitioners a refund of federal income tax pursuant to 28 U.S.C. § 1346(1).[5] App. at 28a.

Respondent appealed to the Tenth Circuit Court of Appeals, raising three issues:

(1) Whether the trial court erred in holding that Judge Wesley E. Brown had the authority to approve a stock option plan on behalf of shareholders;

(2) Whether the trial court erred in allowing the oral testimony of Judge Brown

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[5] Upon a limited remand from the Tenth Circuit, a corrected judgment was entered on July 25, 1994.

> concerning the approval of the plan at a meeting in his chambers where there was no written or official record of such approval; and
>
> (3) Whether the trial court erred in finding that Judge Brown orally approved the stock option plan on behalf of shareholders in the March 20, 1974 meeting in his chambers.

A Tenth Circuit panel reversed the district court, stating (App. at 8a-9a):

> The district court found that Judge Brown approved the plan and, in so doing, acted as the unanimous voice of the shareholders. Upon careful examination of the record, we are convinced that the district court's finding to that effect was clearly erroneous. See O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 901 (10th Cir. 1992). Even if Judge Brown had the power to approve the plan on behalf of the shareholders for IRC purposes, and even if such approval could satisfy the requirements of former § 422, there is simply no evidence in the record that Judge Brown approved the plan on behalf of the shareholders for Internal Revenue (IRC) purposes.

The petitioners filed a petition for rehearing, and suggestion of rehearing *en banc*, raising the issues now presented by this petition for writ of certiorari. Rehearing was denied on October 3, 1994, without any discussion of the issues presented. App. at 51a.

REASONS FOR GRANTING THE WRIT

The present case calls for an exercise by this Court of its supervisory authority. As the Court of last resort in the federal system, this Court exercises an important supervisory role over federal courts. In exercising this role, this Court determines whether a federal appellate decision departs from the accepted and usual course of judicial proceedings. Where a departure has occurred, this Court is called upon on occasion to perform a pure error-correcting function. *Florida v. Rodriguez*, 469 U.S. 1, 7 (1984) (Stevens, J., dissenting).

Petitioners acknowledge that the factual circumstances in the present appeal are very unique, and are not likely to recur. Likewise, petitioners recognize that the statute involved in this case which governs "qualified stock options" has been repealed.[6] Notwithstanding these facts, petitioners submit that proper appellate procedure in the review of federal court decisions has been, and continues to be, an area where this Court should freely exercise its supervisory role to assure procedural due process to the parties. The appearance of procedural due process is particularly important in disputes concerning application of the federal income tax laws to individual taxpayers, because this area of the law affects virtually every United States citizen, and represents the only direct involvement many citizens will ever have with the federal government.

Petitioners submit that the court of appeals departed from proper appellate procedure in this case by

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[6] The new § 422 which governs "incentive stock options," however, contains the same stockholder approval requirement.

failing to apply the clearly erroneous standard of appellate review. Instead, the court of appeals modified and revised, *sua sponte*, the definition of the factual issue presented for trial, and then decided this newly defined issue by a *de novo* consideration of the record.

I.

The court of appeals decided factual issues based upon a de novo review of the record.

In ascertaining whether a federal court of appeals has exercised its proper appellate role, the first inquiry is whether the appellate court applied the correct standard of review. This Court has recently identified and applied the rules which govern appellate review under the clearly erroneous standard. *Anderson v. Bessemer City*, 470 U.S. 564 (1985).

First, a reviewing court oversteps the bounds of its duty under Rule 52(a), Fed. R. Civ. P., if it undertakes to duplicate the role of the lower court, and in applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues de novo. 476 U.S. at 573.

Second, if the district court's account of the evidence is plausible in light of the record viewed in its entirety, an appellate court may not reverse even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. 476 U.S. at 574.

Third, the clearly erroneous standard applies whether the district court's findings rest on physical or documentary evidence, or upon determinations regarding the credibility of live witnesses; however, even greater deference is required when the findings involve the credibility of witnesses. 476 U.S. at 575.

In applying these rules, this Court independently reviews the basis of the appellate court's decision to ascertain whether the proper standard was employed. Even though an appellate court may state that it has applied the clearly erroneous standard, where the court's reasoning strongly suggests that the outcome on appeal was the product of the court's independent consideration of the facts, this Court has not hesitated to reverse and remand for application of the proper standard of review. *See Pullman-Standard v. Swint*, 456 U.S. 273, 290-92 (1982). Such an independent review in the present case demonstrates that the court of appeals did not apply the clearly erroneous standard, but instead substituted its own *de novo* determination of fact.

As the court of appeals opinion recites, the trial court made two pretrial rulings on legal issues: (1) that Judge Brown had authority to exercise stockholder approval under § 422(b)(1) of the IRC, and (2) that Judge Brown acted as the unanimous voice of the stockholders when he exercised authority normally reserved to stockholders. App. at 6a. The court of appeals acknowledged that both of these earlier rulings involved strictly "legal conclusions." *See* App. at 6a. The court of appeals did not purport to reverse these *legal conclusions*, but simply assumed their validity for purposes of the order. App. at 9a.

Instead, the court of appeals concluded that there is ". . . no evidence in the record to establish that Judge Brown approved the plan *on behalf of the shareholders for Internal Revenue Code (IRC) purposes*." App. at 9a (emphasis added). As noted in Section II, *infra*, this statement by the court of appeals modifies and changes the factual issue which was actually decided by the district court. Under the Tenth Circuit's approach, an additional element was added to the factual issue presented in this case. That additional element involved the nature of Judge Brown's approval -- was it merely a "general approval" by Judge Brown acting as a "judicial supervisor," or was it a "specific approval" by Judge Brown acting "on behalf of the shareholders for Internal Revenue Code (IRC) purposes." By revising the statement of the factual issue, the Tenth Circuit began the process of substituting its own findings of fact for the findings of fact made by the district court.

The Tenth Circuit opinion acknowledges that Judge Brown did, in fact, approve the stock option plan. For example, the Tenth Circuit discusses:

- That the plan document was one which Judge Brown *approved*, and that he gave his *approval* of the Plan as presented to him. App. at 13a.

- Portions of Judge Brown's deposition testimony are ". . . supportive of the proposition that Judge Brown's *approval* of the plan was very general in nature." App. at 10a (emphasis added).

- That ". . . we are convinced that Judge

Brown's *approval* of the plan was very general in nature." App. at 14a (emphasis added).

- Trial testimony of the attorney for Clinton (Robert Martin) that the Plan was described to the court, ". . . and Judge Brown said those were fine and he *approved* them." App. at 12a (emphasis added).

On the only factual issue properly identified for trial, *i.e.*, whether Judge Brown approved the Plan on or about March 20, 1974, all of the evidence in the record supports the district court's finding that Judge Brown did, in fact, orally approve the Plan. There is not one iota of evidence to the contrary.

Even though the Tenth Circuit opinion indicates that the court is applying the clearly erroneous standard, the reasoning and language used in the opinion show that the court was actually weighing the record evidence and making its own findings of fact. For example, after citing a portion of Judge Brown's deposition, the Tenth Circuit states that this testimony "implies" that Judge Brown never intended that his general approval of the plan be on behalf of the stockholders and in satisfaction of the stockholder approval requirement of § 422. App. at 9a. The order then states that other deposition testimony "appears" to contradict the district court's finding. App. at 10a.

The Tenth Circuit also reasons that had Judge Brown been approving the plan on behalf of stockholders, he "presumably" would have suggested that the boilerplate clause requiring stockholder approval be stricken from the

Plan. App. at 13a. The court then concludes that because this clause was not stricken, this ". . . suggests that his [Judge Brown's] general approval was never intended to be a substitute for shareholder approval, as required by § 422." App. at 13a.

Finally, the court seems to suggest that Judge Brown's failure to inquire about the details required to make the Plan a "qualified stock option" plan under the IRC, as well as his failure to question counsel about the "tax effects" of the Plan, caused his approval to fail to comply with §422. App. at 12a. While these statements seem to imply that Judge Brown might not have given serious consideration to his approval of the Plan, and the consequences to Clinton's stockholders, the evidence is to the contrary.

At the March 20, 1974 meeting, the Plan was described to Judge Brown -- what it was, who was going to benefit, and why it was needed. Judge Brown was given a copy of the plan, and he read it. Clinton's counsel testified that during the proceedings in W-5020 he never handed Judge Brown a document that the judge did not look at page-by-page, and that Judge Brown certainly did not "rubber-stamp" any matters. To suggest that Judge Brown's approval was too "general" in nature to meet some requirement in the IRC is contrary to the evidence in the record and the findings of the district court.

Moreover, the Tenth Circuit does not identify precisely what specific "tax effects" of a qualified plan would have been important for Judge Brown to inquire about before he approved the Plan. Nor does the Tenth Circuit explain how such further inquiry might have

furthered the Congressional purpose underlying the requirement for stockholder approval of qualified stock option plans.

Congress incorporated the stockholder approval requirement into §422(b)(1) to ensure that a grant of qualified options by a corporation would be in accordance with the stockholders' desires, and to enable stockholders to protect their equity interest in the granting corporation.[7] Judge Brown's actions in approving the Plan clearly accomplished the basic purpose of § 422, by protecting Clinton's stockholders from an unfair dilution of their equity interest. For example, Judge Brown unequivocally stated that the directors would not be eligible to receive options under the Plan, and he also stated that no officer was to receive more shares under the 1974 Plan than Clinton's CEO had received pursuant to his 1973 employment contract (which also had been approved by Judge Brown). In fact, protection of the Clinton stockholders was the very reason for the filing of the SEC action, and for the subsequent approval by the SEC of the order that authorized Judge Brown to exercise all rights of the Clinton stockholders. Judge Brown gave Clinton's stockholders more protection than Congress ever contemplated when it enacted the stockholder approval requirement of § 422(b)(1).

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[7] The issues addressed by Congress in enacting the stockholder approval requirement, however, arise with respect to both qualified and nonqualified options. The potential for unfairly diluting stockholders' equity can occur under either type of stock option plan (*e.g.*, if the option price is less than the fair value of the shares subject to the option) and, the stockholders have an interest in approving any stock option plan adopted by their corporation.

While the Tenth Circuit order stated that the court was applying the clearly erroneous standard, each time the court referred to testimony in the record which it viewed as negating a "specific intent" to approve the Plan on behalf of the stockholders for IRC purposes, the words used, *e.g.*, "implies", "appears", "presumably", and "suggests", clearly show that the court of appeals was weighing the evidence and was making its own findings of fact.[8] By so acting, the court of appeals improperly undertook to duplicate the fact-finding role of the district court.

This Court has emphasized that a trial judge is in a superior position to make determinations of credibility, noting that "[T]he trial judge's major role is the determination of fact, and with experience in fulfilling that role comes expertise." *Anderson v. Bessemer City*, 470 U.S. at 574. The trial judge in this case had the opportunity to determine the credibility of the witnesses at trial, and to weigh the trial testimony with other corroborative evidence. When the court of appeals substituted its own view of the facts, based solely on the printed record, it overstepped the bounds of its duty under Rule 52(a), Fed. R. Civ. P., and denied the petitioners their right to procedural due process of law.[9]

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[8] The use of such tentative language also raises a question as to whether the court had really reached "a definite and firm" conviction that a mistake had been committed.

[9] This Court has stressed that proper appellate review is an important part of procedural due process. *See Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 20-21, 23 (1991); *TXO Production v. Alliance Resources*, 509 U.S. __, __, 125 L.Ed.2d 366, 387, 113 S.Ct. 2711, 2727 (1993) (Scalia, J, concurring); *Honda Motor Co. v. Oberg*, 512 U.S. __, 129 L.Ed.2d 336, 114 S.Ct. 2331 (1994).

II.

The court of appeals modified and revised, sua sponte, the factual issue to be decided.

As previously noted, the district court identified the factual issue remaining to be tried as ". . . whether the Honorable Wesley E. Brown, United States District Judge, approved the 1974 stock option plan of Clinton Oil Company ("Clinton") . . . . App. at 16a. The district court had already reached the *legal conclusion* that "[W]hen Judge Brown exercised authority normally reserved to the stockholders, he acted as the unanimous voice of the stockholders." App. at 47a, 16a. Therefore, the question of whether Judge Brown specifically intended his approval of the Plan to be in lieu of approval of the stockholders of Clinton for IRC purposes was never an issue at trial. In finding that Judge Brown had orally approved the Plan at a meeting in his chambers on March 20, 1974, App. at 22a, 25a, the district court specifically discussed the credibility of the witnesses, and the fact that other evidence corroborated its finding. App. at 24a-25a.

Rather than addressing the narrow factual issue identified by the trial court, the court of appeals, *sua sponte*, modified and changed the factual issue presented in this case. Although the court of appeals acknowledged that Judge Brown had approved the Plan, it revised the factual issue by focusing on whether Judge Brown's approval was only a "general approval" or whether it was "specifically intended" to be approval (1) on behalf of stockholders of Clinton, and (2) for Internal Revenue

Code (IRC) purposes.[10] This is not the factual issue identified in the pretrial order, by the parties' trial briefs, by the parties' statements at trial, or by the district court in its findings.

Having framed a new factual issue, the Tenth Circuit proceeded to review the evidence *de novo* concerning the nature of Judge Brown's approval. Failing any direct evidence or testimony about Judge Brown's intent, the court recited certain "indirect" evidence which it believed could lead to an "inference" that when Judge Brown approved the Plan he intended to act only in a "general" manner as a "judicial supervisor" of Clinton, and not on behalf of Clinton's stockholders for IRC purposes.

The question of whether Judge Brown specifically intended that his approval satisfy § 422(b)(1), or that the options issued under the Plan be treated as "qualified" options under the tax code, is irrelevant. The order signed by Judge Brown on March 8, 1973 approving the settlement of the SEC litigation vested Judge Brown with all powers of the Clinton stockholders. When Judge

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[10] If the nature of Judge Brown's "intent" in approving the Plan was an issue in this case, it would be a factual matter, subject to the clearly erroneous rule. *See Pullman-Standard v. Swint*, 456 U.S. 273, 288-90 (1982). *See also Commissioner v. Duberstein*, 363 U.S. 278 (1960) (under IRC, intent or motive of a donor is a fact question subject to the clearly erroneous rule). Therefore, even if the court of appeals correctly defined the factual issue to be decided, since the trial court made no factual finding about the nature of Judge Brown's intent (as compared to its legal conclusion that Judge Brown acted on behalf of stockholders, *See* App. at 47a), the Tenth Circuit should have remanded the case to the district court for further findings on that issue, rather than make its own factual findings. *Pullman-Standard v. Swint*, 456 U.S. at 291.

Brown approved the Plan on or about March 20, 1974, his act had the force and effect of a unanimous, affirmative vote of the Clinton stockholders, and his approval satisfied § 422(b)(1).

Nor does the legislative history of § 422(b)(1) provide a basis for the court's expansion of the statute to include a specific intent test. There is no basis in the legislative history of § 422(b)(1) which would require that stockholders specifically intend either that their actions satisfy the tax statute or that the options constitute qualified options.[11] Moreover, the purpose of the stockholder approval requirement, *i.e.*, protection of existing stockholder's interests from dilution, is not advanced by adding an additional requirement that the stockholders must specifically intend that options be treated as qualified options. *See supra* note 7.

The Tenth Circuit's factual inquiry into the nature of Judge Brown's approval of the plan, *e.g.*, whether he was approving it "generally" as a "judicial supervisor," or

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[11] If correct, the court's analysis could lead to inquiries as to whether stockholders adopting a qualified stock option plan were aware of the tax treatment of the plan or whether they understood (or even reviewed) the plan description included in the proxy material soliciting their approval of the plan. There is no indication that Congress or the IRS have ever contemplated such an intensive analysis of the stockholders' knowledge, motive or intent in voting for a stock option plan. Instead, all the statute and regulations require is that the approval comply with state law requirements. For example, the new regulations issued under §422 governing "incentive stock options" implicitly recognize that the stockholders' intent is irrelevant to the stockholder approval requirement, by providing that the question of whether stockholder actions satisfy §422 is determined under the issuing corporation's controlling state law. See 26 C.F.R. §1.422-5 (1994). The regulations impose no additional standards.

specifically for the purpose § 422, has no legal support in the statute, its legislative history, or the regulations.

The Tenth Circuit decided a factual issue which was never presented to or decided by the district court. To paraphrase the words of this Court in *Anderson v. Bessemer City*, 470 U.S. at 575, the petitioners in this case concentrated their energies on persuading the trial judge that Judge Brown had approved the Plan; requiring them to persuade three more judges at the appellate level, not only that Judge Brown approved the Plan, but that he approved it with the specific intent to act on behalf of Clinton's stockholders for tax purposes, is requiring too much.

CONCLUSION

For the reasons set forth above, this petition for certiorari should be granted. However, because of this Court's recent decision in *Anderson v. Bessemer City*, 470 U.S. 564 (1985), which provides a clear guide to federal appellate courts concerning proper application of the clearly erroneous standard of review, petitioners respectfully submit that the Court can exercise its supervisory role without the necessity of full briefing and oral argument in this case.

The petitioners, therefore, respectfully request the Court to enter an order pursuant to Rule 16.1, summarily disposing of this petition on the merits, granting the petition, reversing the order and judgment of the Tenth

Circuit Court of Appeals, and reinstating the opinion and judgment of the District Court for the District of Kansas entered on June 22, 1992.

Respectfully submitted,

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December 30, 1994

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 92-3295
D.C. No. 88-CV-1493T)
(D. Kan.)

ROBERT A. BROOKS and CAROL M. BROOKS,

Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

ORDER AND JUDGMENT*
Entered August 3, 1994

Before LOGAN, SETH, and BARRETT, Circuit Judges.

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* This order and judgment is not binding precedent, except under the doctrines of law of the case, res judicata, and collateral estoppel. The court generally disfavors the citation of orders and judgments; nevertheless, an order and judgment may be cited under the terms and conditions of the court's General Order filed November 29, 1993. 151 F.R.D. 470.

After examining the briefs and appellate record, this panel has determined unanimously that oral argument would not materially assist the determination of this appeal. See Fed. R. App. P. 34(a); 10th Cir. R. 34.1.9. The case is therefore ordered submitted without oral argument.

This appeal raises the issue of whether a stock option exercised by taxpayers Robert and Carol Brooks was a qualified stock option within the meaning of 26 U.S.C. § 422(b)(1).[1] Pursuant to an employee stock option plan, taxpayers exercised an option to purchase 60,000 shares of stock in Clinton Oil Company.[2] As a result, they reported income on their 1980 return in the amount of the difference between the exercise price and the fair market value of the stock. Taxpayers filed a complaint in the United States District Court for the District of Kansas seeking a tax refund of $210,253 plus interest, because they claim that the 1980 stock purchase was a qualified stock option within the meaning of the Internal Revenue Code and, therefore, that they were not obligated to recognize income in the amount of the difference between the exercise price and the fair market value of the stock.

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[1] Section 422, which was the statute governing qualified stock options during the time period relevant to this action, was added to the Internal Revenue Code of 1954 by Pub. L. No. 88-272, 78 Stat. 64, in 1964. That section was repealed by Pub. L. No. 101-508, 104 Staf. 1388-521, in 1990 and was replaced by the current § 422 governing "incentive stock options," formerly § 422A, which was added in 1981 by Pub. L. No. 97-34, 95 Stat. 256.

[2] Robert Brooks was employed by Clinton Oil Company, which was the predecessor of Energy Reserves Group, Inc.

After a bench trial, the district court found that taxpayers were entitled to a refund for 1980 because the stock purchase was a qualified stock option. On appeal, the government raises three issues: 1) whether the judicial supervisor, Honorable Wesley E. Brown, Senior Judge, United States District Court for the District of Kansas, had the authority to approve the stock option plan on behalf of the stockholders for purposes of 26 U.S.C. § 422(b)(1); 2) whether approval of the plan by Judge Brown could be established absent a written order or official record of the action; and 3) whether Judge Brown approved the plan on behalf of the stockholders. For the reasons set forth below, we reverse.

FACUTAL BACKGROUND

Clinton Oil was the subject of a suit for injunctive relief brought by the Securities and Exchange Commission (SEC) on January 15, 1973. The action, presided over by then Chief Judge Wesley E. Brown, sought preliminary and permanent injunctive relief and appointment of a receiver to take control of and conduct the business of Clinton Oil until further order of the court. Because Clinton's major assets were oil and gas concessions subject to cancellation upon appointment of a receiver, Clinton's management and the SEC reached a settlement agreement that, in lieu of appointing a receiver, Judge Brown would act as judicial supervisor. Judge Brown consented to act as judicial supervisor pursuant to the settlement agreement, and on March 8, 1973, the court entered an order approving the settlement (the order).

The order set forth Judge Brown's duties and responsibilities as judicial supervisor in connection with the SEC settlement. With the objective of restructuring the management and board of directors under Judge Brown's supervision, the order specifically provided that Judge Brown had the authority to designate a President and Chief Executive Officer from a list of names satisfactory to the SEC. If no recommendation was made, or if Judge Brown chose not to designate anyone recommended, Judge Brown was then authorized to designate a qualified person who was satisfactory to the SEC. The order also gave Judge Brown the specific authority to appoint a certified public accounting (CPA) firm and special counsel, both to be satisfactory to the SEC.[3] Finally, Judge Brown, as judicial supervisor, was specifically given the authority to approve, along with the SEC, the individuals submitted by counsel to serve as directors.

As a more general matter, the order anticipated that the newly-appointed president would perform the duties and exercise the powers enumerated in the order, subject to the jurisdiction of the court. Finally, the order stated that:

> [t]he plaintiff [SEC's] request for appointment of a receiver and relief not afforded by this order as against Clinton Oil Company will be

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[3] Specific duties of the CPA firm and special counsel were enumerated in the order, all with the apparent short-term goal of uncovering and remedying any irregularities regarding: 1) monies paid or loaned to present or former officers, directors, or their relatives; and 2) credit extended by Clinton in connection with the sale of oil and gas interests or the purchase of securities.

> discontinued, without [sic] prejudice, at the time the new Chief Executive Officer and Board of Directors assume their duties. The Court hereby retains jurisdiction with respect to all matters relating to the implementation, accomplishment and enforcement of the acts to be done pursuant to the terms of the settlement agreement, this order and the order of permanent injunction against the Company as made and entered, and to make such further orders as may be necessary and appropriate in connection therewith.

Appellant's App. III at 479. In accordance with the authority contemplated in the settlement agreement and granted in the order, Judge Brown entered several orders between January 1973 and August 1976 appointing a president and approving his employment agreement, appointing officers and directors, appointing special counsel, and appointing accountants. Judge Brown sought input from the SEC regarding all those matters and his actions were memorialized by formal written orders.

On March 18, 1974, Clinton's board of directors adopted three employee benefit plans: a stock option plan, a thrift savings plan, and a profit-sharing plan. Not long after that, the plans were submitted to Judge Brown for his approval. Judge Brown indicated in his deposition testimony that he had no specific recollection of approving the stock option plan, but that if the board of directors had approved it and the SEC had no objection, then he was sure he had approved it.

PROCEDURAL BACKGROUND

After taxpayers filed suit for a tax refund, the parties filed cross motions for summary judgment in the district court. Taxpayers argued that the affidavits and documents attached to their motion supported a finding that Judge Brown had orally approved the stock option plan on behalf of the stockholders in a meeting in his chambers on March 20, 1974. The government maintained that, absent a written order or transcript of the meeting, Judge Brown took no official action to approve the plan, thereby entitling the government to summary judgment. In addition, it argued that, even though it was disputed whether Judge Brown had approved the plan at all, summary judgment was appropriate because Judge Brown's approval could not substitute for stockholder approval as required by § 422(b)(1).

The district court examined the legislative history of § 422 and found that a strict interpretation of the statue, requiring actual stockholder approval, would not further the statutory purpose. To that end, it found that Judge Brown acted as the unanimous voice of the stockholders and that such action was sufficient to satisfy the requirements of § 422. Despite its legal conclusions in the taxpayers' favor, the district court granted the government's motion for summary judgment because it found insufficient evidence to demonstrate a genuine issue of fact as to whether Judge Brown actually approved the plan. In so holding, the district court noted that the record contained no evidence of a present recollection by Judge Brown of approving the plan.

In response to the district court's order granting summary judgment in favor of the government, taxpayers moved to alter or amend or reconsider the judgment, requesting leave to take Judge Brown's deposition. The government responded that a deposition was unnecessary because the absence of any written order or transcript was dispositive. However, the district court granted taxpayers' motion. Taxpayers then submitted a supplemental memorandum in support of their motion to alter, amend or reconsider judgment, arguing that Judge Brown's deposition, together with the previously submitted affidavits, presented a genuine issue of material fact. The district court granted the motion for reconsideration, finding that a genuine issue of fact existed, and the case was tried to the court.

After trial, the district court relied on its previous rulings that Judge Brown had the authority to exercise stockholder approval within the meaning of § 422(b)(1) and that he acted as the unanimous voice of the stockholders when he exercised authority normally reserved to stockholders. The court found that Judge Brown did approve the stock option plan and entered judgment for taxpayers.[4]

DISCUSSION

Former section 422(b)(1) of the Internal Revenue Code, 26 U.S.C., states that a stock option granted to an individual

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[4] The district court originally entered judgment for taxpayers on June 22, 1992. We remanded the case to the district court on June 7, 1994, so that the judgment could be corrected to reflect the amount of the judgment and any interest thereon. The corrected judgment was entered on July 25, 1994.

in connection with his employment by a corporation is a qualified stock option if "the option is granted pursuant to a plan which . . . is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted . . . ." The relevant Treasury Regulation also requires stockholder approval of a stock option plan within twelve months before or after adoption of the plan, if a stock option is to be considered a qualified stock option. 26 C.F.R. § 1.422-2(b)(1) (1980). The regulation further states that

> [t]he approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting.

There is no dispute that the Clinton shareholders did not approve the stock option plan adopted by the board of directors within twelve months before or after its adoption. Taxpayers argue, and the district court found, that Judge Brown had the authority as judicial supervisor to approved the plan on behalf of the stockholders and that he did, in fact, do so.

The district court found that Judge Brown approved the plan and, in so doing, acted as the unanimous voice of the shareholders. Upon careful examination of the record, we are convinced that the district court's finding to that effect was

clearly erroneous. See O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 901 (10th Cir. 1992). Even if Judge Brown had the power to approve the plan on behalf of the shareholders for IRC purposes, and even if such approval could satisfy the requirements of former § 422, there is simply no evidence in the record that Judge Brown approved the plan on behalf of the shareholders for Internal Revenue Code (IRC) purposes. In fact, Judge Brown's own deposition testimony implies that he would not have taken such action:

> Q. Was there ever any discussion at any point in time with regard to the employee stock option plan, a discussion referring to whether it was qualified or non-qualified within the meaning of the Internal Revenue Code?
>
> A. No, no, no. I wouldn't have known and I would have turned it over to the lawyers to decide that. They wouldn't -- I wouldn't pass on whether it was taxable or not.
>
> Q. Do you have a present recollection of discussing with Mr. Volk, Mr. Martin or Mr. Woods that it was necessary for you to approve the employee stock option plan on behalf of the shareholders?
>
> A. . . . if there was a legal basis that required stockholder approval I would have told them to take whatever necessary steps were required . . .

Appellant's App. Vol. I at 119-20. This testimony supports the conclusion that Judge Brown never intended that his general approval of the plan be on behalf of the stockholders and in satisfaction of the stockholder approval requirement of § 422.

In addition to the above-quoted testimony that appears to contradict the district court's finding, Judge Brown's deposition contains statements supportive of the proposition that Judge Brown's approval of the plan was very general in nature. When considered as a whole, the judge's testimony indicates a general practice of Clinton board members and management running all nature of things by him for his general approval and comment. The Judge would invariably approve the matter if the board had approved it and if there was no objection by the SEC. For instance, in discussing his recollection of the plan, Judge Brown stated:

> Well, I guess that the board of directors that I said I didn't want them in there, that I would not approve it if they brought it to me [referring to the fact that Judge Brown was opposed to including the directors in any stock option plan]. Otherwise I'm sure that I approved it but I have no recollection of the kind of approval except that it was not to go to the board of directors and that, my approval would have been very frankly if the board of directors thinks this is a good business judgment, I have nothing to, no reason not to approve it.

Id. at 117. In response to an affidavit indicating it was not the general practice of the court to record each conference or decision by formal court order, Judge Brown stated:

> My problem is that I'm not sure they were decisions. If it was a decision I required an order in the file. They were meetings which they would come in and we'd have skull practice, you would call it that way. I think they would come in and ask me what I thought on it and if there was any conflict or any disposition they would tell me that they reported it to the Securities Exchange Commission and I would say, "If there is no conflict, I have no objection to it." Or if it came up with something that I had some feeling in the manner of a suggestion but not to take away the authority of the board.

Id. at 113. Also commenting on the court's practice, Judge Brown noted that "if there was a matter in which the Court was making a specific ruling other than merely keeping my board of directors content from worrying, it would have been on the record. I don't do anything that isn't on the record." Id. at 119. Finally, in response to an inquiry as to his recollection of discussion concerning why a stock option plan was desired, Judge Brown replied: "How it was to work, the details, what it was, I don't think they presented it to me. If they had of, I would have told them to just go back and keep it within the law." Id. at 106.

Trial testimony of others also speaks to the very general supervisory nature of Judge Brown's actions. Referring to

the benefits package (thrift plan, stock option plan and profit sharing plan) presented to Judge Brown for his approval, Robert Martin, counsel for Clinton, testified that the three plans were described to the court and it was explained who was to benefit from the plans and why they were needed, "and Judge Brown said those were fine and he approved them." Appellant's App. Vol. II at 189. When questioned regarding the circumstances surrounding Judge Brown's approval of the stock plan, Martin responded as follows:

> Q. Was Judge Brown told that shareholder approval was necessary to have a qualified plan?
>
> A. No, not that I recall.
>
> Q. Did you discuss the tax effects for the executive of a qualified versus nonqualified plan with Judge Brown?
>
> A. I didn't. And I don't recall that being discussed in his presence. It was assumed that he knew it, I'm sure was the case.
>
> Q. Did you discuss the tax effects of the qualified option versus nonqualified option with respect to the company with Judge Brown at this meeting?
>
> A. No.

Id. at 196-97. Addressing his recollection of the nature of Judge Brown's approval, Richard Volk, court-appointed president and chief executive officer of Clinton, made this

comment: "I guess the best word I would -- I could use in terms of running the company then that I felt I had his tacit approval on the documents that I sent to the shareholders, on the plans . . . ." Id. at 288.

As further evidence of the nature of Judge Brown's approval, the plan itself contained a clause stating:

> This Plan, which has been adopted by the Board of Directors on the 18th day of March, 1974, shall be subject to approval by the stockholders of the Company within twelve (12) months after March 18, 1974; however, the disapproval by the shareholders of this Plan or the failure of the shareholders to vote on this Plan shall in no way affect the Plan other than the Plan's qualifications for Internal Revenue purposes.

Appellant's App. Vol. III at 390. The very document that Judge Brown approved alluded to the shareholder approval requirement for IRC purposes. Presumably, had Judge Brown's approval been on behalf of the shareholders and in satisfaction of § 422, Judge Brown would have suggested that the plan document be adjusted accordingly. The record contains no evidence that Judge Brown even commented on the above-quoted clause; his approval of the plan as presented to him, including that clause, suggests that his general approval was never intended to be a substitute for shareholder approval, as required by § 422.

After studying the entire record, including Judge Brown's deposition, relevant affidavits, and the trial transcript, we are convinced that Judge Brown's approval of the plan was very general in nature. There is no evidence whatsoever to indicate that Judge Brown approved the stock option plan on behalf of and as the unanimous voice of the shareholders in satisfaction of § 422. Accordingly, we REVERSE the judgment of the district court in favor of taxpayers.

Entered for the Court

James E. Barrett,
Senior Circuit Judge

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF KANSAS

ROBERT A. BROOKS and CAROL M. BROOKS,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

CIVIL ACTION No. 88-1493-T.

June 22, 1992

Donald W. Bostwick, Adams, Jones, Robinson & Malone, Wichita, Kan., for plaintiffs.

Mary Dee Martoche, Office of Special Litigation, Tax Di, U.S. Dept. of Justice, Washington, D.C., Annette B. Gurney, Office of U.S. Atty., Wichita, Kan., for defendant.

DECISION OF THE COURT

THEIS, District Judge.

Plaintiffs brought this action seeking a refund of taxes paid for the 1980 tax year. Plaintiffs seek a determination that an employee stock option exercised by Robert A. Brooks (Brooks) was a "qualified stock option" within the meaning of 26 U.S.C. § 422(b)(1).

In a previous memorandum and order published at 766 F.Supp. 993, the court granted the United States' motion for summary judgment. Upon the plaintiffs' timely motion to alter or amend or to reconsider, the court allowed plaintiffs to take the deposition of the Honorable Wesley E. Brown. The court thereafter considered Judge Brown's deposition and found that an issue of fact precluded summary judgment. The court then granted the motion to reconsider.

The court has addressed most of the issues in previous opinions. The narrow factual issue remaining for trial was whether the Honorable Wesley E. Brown, United States District Judge, approved the 1974 stock option plan of Clinton Oil Company ("Clinton") (now known as Energy Reserves Group, Inc.). The issues of law (which the court has previously addressed) are whether Judge Brown was authorized to act in the place of the stockholders and whether the lack of an official record (written order or transcript of hearing) is fatal to plaintiffs' claim of judicial approval of the stock option plan.

This matter was tried to the court on June 15, 1992. The court heard the testimony of several witnesses and had the opportunity to evaluate their demeanor and credibility. The court also received into evidence the deposition of Judge Brown. The court has considered the testimonial evidence

and the exhibits and now issues the following findings of fact and conclusions of law.

FINDINGS OF FACT

In ruling on the motions for summary judgment, the court found the following facts to be uncontroverted. *See* 766 F.Supp. at 994-95.

1. On January 15, 1973, the Securities and Exchange Commission ("SEC") filed an injunction action in this court against Clinton, the predecessor of Energy Reserves [hereinafter *SEC v. Clinton*].

2. Presiding over the injunction action was the Honorable Wesley E. Brown.

3. On February 1, 1973, the Joint Shareholders Protective Committee of Clinton ("the Committee") filed a motion to intervene in *SEC v. Clinton*. Attached to this motion was the proposed complaint of the Committee requesting, among other relief, an order directing Clinton to allow inspection of its stock ledger and stockholder list, and to have the list filed with the court; and an order directing Clinton to notice and convene a meeting of its stockholders under the supervision of the court so that the stockholders could express their views, elect directors, and deal with all other appropriate matters.

4. By order filed February 27, 1973, Judge Brown found the application to intervene premature, and therefore held the application in abeyance. Judge Brown also denied

the application of the Committee to inspect Clinton's stock ledger.

5. On March 8, 1973, Judge Brown approved a settlement entered into by the parties of *SEC v. Clinton.* According to this settlement, Judge Brown assumed certain duties and responsibilities in connection with Clinton's reorganization.

6. On March 9, 1973, Judge Brown entered an order appointing special counsel or Clinton to take such action and exercise such authority as set forth in the arch 8 order approving settlement.

7. On March 16, 1973, Judge Brown entered order designating and approving certain individuals to serve as directors of Clinton to "serve subject to the continuing jurisdiction of the court with respect to all matters relating to the implementation, accomplishment, and enforcement of the acts to be done pursuant to the Memorandum of Understanding of Terms of Settlement and the order of the court entered thereon."

8. On May 11, 1973, Judge Brown entered an order establishing the fees to be paid to the directors for their services.

9. On June 4, 1973, Judge Brown entered an order appointing a certified public accounting firm to conduct the accounting and make the report required by his prior order of March 8, 1973.

10. On May 29, 1973, and with consent of the SEC, Judge Brown entered an order approving and appointing Richard W. Volk as President and Chief Executive Officer of Clinton, and approving a written agreement of employment between Volk and Clinton that had been approved by Clinton's board of directors.

11. On March 18, 1974, the directors of Clinton adopted the Clinton Oil Company 1974 stock option plan that is at the heart of this dispute.

12. The last meeting of the shareholders before March 18, 1974 was on June 3, 1971. The first meeting of the shareholders following March 18, 1974 was on July 14, 1976. Thus, the March 18, 1974 stock option plan was not approved by a majority of the shareholders within 12 months either before or after the directors approved the plan.

13. On July 2, 1976, and on the motion of Energy Reserves (formerly Clinton), Judge Brown entered an order that approved the holding of an annual meeting of the stockholders of Energy Reserves to be held on July 14, 1976, and that established the procedure for examination of the list of stockholders of Energy Reserves.

14. By orders filed July 27, 1976, Judge Brown terminated the appointment of special counsel for Clinton, and terminated the court's jurisdiction and supervision as assumed by the court on March 8, 1973.

15. On June 17, 1980, plaintiff exercised his option as offered in the 1974 stock option plan. The fair market

value of the stock at that time exceeded the exercise price of the option by $603,750.00, which was treated by the Internal Revenue Service as a gain. As a result of and directly attributable to this gain, plaintiffs paid $210,253.00 for the 1980 tax year.

Based on the testimony at trial, the court makes the following additional findings.

16. Attorney Robert Martin represented Clinton in *SEC v. Clinton*. Martin quickly ascertained that Clinton had committed clear violations of the securities laws, and the SEC was certain to prevail in the action.

17. The SEC had sought temporary and permanent injunctive relief and the appointment of a receiver for Clinton. Clinton wished to avoid certain adverse consequences which would result from the appointment of a receiver.[1] Martin proposed and SEC attorney Richard Hewitt agreed to have Judge Brown act in the role of judicial supervisor instead of having a receiver appointed. The SEC and Clinton agreed to settlement of the litigation which placed Clinton under court supervision. Plaintiffs' Exh. A, Tab 14 (Memorandum of Terms of Settlement), Tab 15 (Order Approving Settlement) (both filed March 8, 1973).

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[1] Clinton owned valuable undeveloped oil leases abroad, particularly in the North Sea off Britain, which were a principal asset of Clinton. All these foreign leases provided that the foreign government could terminate the lease if Clinton went into receivership or bankruptcy. Counsel for both Clinton and the SEC wished to avoid this consequence.

18. Pursuant to the Order Approving Settlement, Judge Brown retained the right to appoint the board of directors, special counsel, and an auditor.

19. By Order dated March 16, 1973, Judge Brown appointed Clinton's new board of directors. Henry L. Waszkowski, Jr. was designated to serve as President and Chief Executive Officer of Clinton. Plaintiffs' Exh. A, Tab 16. Judge Brown later removed Waszkowski when it became known that Waszkowski was not willing to move to Wichita and devote his full time to the position.

20. Clinton thereafter sought to hire Richard W. Volk to serve as President and Chief Executive Officer.

21. At a meeting in chambers in approximately late May 1973, Judge Brown objected to certain provisions of the draft employment agreement drawn up by Volk, specifically a provision which would require Clinton to pay Volk's full salary for the entire three year term if Volk were fired without cause. The parties agreed to a modification of this provision which met Judge Brown's approval.

22. At this same meeting in late May 1973, Judge Brown approved the stock option contained in Volk's draft employment agreement. Judge Brown was informed at that time that Volk intended to offer stock options to attract competent new officers and employees to Clinton.

23. At this same meeting in chambers, Judge Brown refused a suggestion that Clinton's directors be granted stock options. Judge Brown noted that he appointed outsiders as

directors so that they would not have a financial stake in Clinton.

24. Clinton and Volk entered into a written employment agreement which contained a stock option agreement. The employment agreement contemplated the probability of future employee stock option plans, and granted Volk the right to participate in any future plans. Plaintiffs' Exh. A, Tab 19, ¶¶ 7-8.

25. Judge Brown approved the hiring of Volk and the written employment agreement entered into between Volk and Clinton in an order dated May 29, 1973 (filed June 18, 1973). Plaintiffs' Exh. A, Tab 20.

26. At a meeting on March 18, 1974, Clinton's board of directors approved an employee benefits package, which included the 1974 stock option plan.

27. At a meeting with Judge Brown in chambers on March 20, 1974, Judge Brown orally approved a benefits package for Clinton employees, including the 1974 stock option plan at issue here.

28. Also present at the March 20, 1974 meeting with Judge Brown were attorney Martin, director Paul Woods and Volk. The SEC's Hewitt appeared either in person on by telephone.

29. No meeting of the stockholders was held in the twelve months before or the twelve months after the adoption of the stock option plan.

30. The reasons for the failure to hold stockholders meetings are not material to the resolution of this action; however, it appears that one reason meetings were not held was the fear of a takeover by certain stockholders.

31. On July 27, 1976, Judge Brown terminated his supervision of and jurisdiction over Clinton. Exh. A, Tab 23.

32. The form of remedy approved in the settlement of *SEC v. Clinton*--the substitution of a Federal Judge for a receiver--was unique at the time.[2] The SEC intended that Judge Brown stand in the place of the stockholders.

33. Director Paul Woods met with Judge Brown on a frequent and informal basis. On more important matters, Martin, Volk and a representative of the SEC would also be present.

34. While Judge Brown does not specifically recall the approval of the 1974 stock option plan on a certain date, Judge Brown did testify regarding a general practice under which the Clinton parties would report proposed actions to him. If the Clinton board of directors approved of the stock option, Judge Brown testified that he would have had no reason not to approve it.

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[2] This type of judicial supervision of corporate affairs has since become more common, especially in multidistrict litigation, and is an example of the court's equity powers to fashion an adequate remedy.

35. Judge Brown testified that he had the distinct recollection that he disapproved the directors' request to participate in the stock option plan.

36. The SEC was consulted on all matters which went before the court.

37. The SEC had no objections to the stock option offered to Volk in 1973 as a part of his employment agreement. Hewitt had no specific recollection of the 1974 employee stock option plan at issue in the present action. Hewitt testified from his general recollection that Martin would not have approached Judge Brown on such an important matter without ascertaining Hewitt's opinion first. Hewitt testified that the SEC would have had no objection to the 1974 stock option plan.

38. The court found all the witnesses to be credible. The court found especially credible SEC attorney Hewitt, who was the lead attorney in *SEC v. Clinton* and is an uninterested witness. The court found the testimony of Volk to be credible, notwithstanding his pending tax refund claim which involves the same legal and factual issues as the present case.

39. The witnesses--both interested and uninterested--recounted the same basic facts. The testimony of the other witnesses corroborated Judge Brown's recollection that he may have orally approved the stock option plan. Other corroborative evidence includes the employment contract between Clinton and Volk which included a stock option, which was approved by Judge Brown

in a formal written order. The Volk employment agreement anticipated future stock option plans. Plaintiffs' Exh. A, Tab 19. The stock option plan at issue here provides the stock options for certain employees, with no stock option provision for directors. Plaintiffs' Exh. C. This is in conformity with Judge Brown's distinct recollection of his disapproval of the stock option for directors.

40. The affidavit of director Woods is hearsay. The court finds the affidavit to be reliable, since the facts contained therein are corroborated by the testimony of the witnesses. However, since Woods' affidavit is merely corroborative, it is unnecessary for the court to rely on the affidavit in reaching its decision.

41. The stock option proposal was presented to Judge Brown in an informal meeting in chambers. Judge Brown orally approved of the employee stock option plan, agreeing that it was an appropriate means to recruit new talent to Clinton.

42. Judge Brown, acting as the unanimous voice of the Clinton stockholders, orally approved the 1974 employee stock option plan.

CONCLUSIONS OF LAW

The ultimate issue presented is whether the option exercised by plaintiff in 1980 was a "qualified stock option" within the meaning of § 422 of the Internal Revenue Code of 1954.

The statute provides:

> For purposes of this part, the term "qualified stock option" means an option granted to an individual ... for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if--
>
> (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under option, and the employees ... eligible to receive options, *and which is approved by the stockholders of the granting corporation* within 12 months before or after the date such plan is adopted; ....

26 U.S.C. § 422(b)(1) (emphasis added).

The Treasury Regulation implementing this statute provides:

> A qualified stock option granted after December 31, 1964, must be granted pursuant to a plan *which is approved by the stockholders of the granting corporation* within 12 months before or after the date the plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express

> consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting.

26 C.F.R. § 1.422-2(b)(1) (emphasis added).

The court has previously ruled that Judge Brown was authorized to act as the proxy for the stockholders within the meaning of § 422(b)(1) and that the absence of a written order of approval was not fatal to plaintiffs' claim. The court shall not repeat the entire discussion here and incorporates herein its previous discussion of the issues. *See* 766 F.Supp. 993, 995-98.

The language of § 422(b)(1) refers only to stockholder approval to qualify a stock option for tax purposes. The court has previously ruled, however, that Judge Brown had the authority to exercise stockholder approval within the meaning of § 422(b)(1).

The court's conclusion is consistent with the legislative intent. The purpose of granting favorable tax treatment to qualified options was to allow corporations to offer employment incentives. The requirement of stockholder approval ensures that the stock option offerings would not operate to the detriment of the stockholders' interests. Judge Brown represented the interests of the shareholders in his oversight of Clinton. When Judge Brown exercised authority normally reserved to the stockholders, he acted as the unanimous voice of the stockholders. A contrary conclusion is inconsistent with the intent of Congress.

There is no written order by Judge Brown approving the 1974 stock option plan. Nor is there a transcript of any proceeding in which Judge Brown approved the plan. However, oral testimony of the persons attending the March 1974 meeting is sufficient to establish the fact of his approval. As the court previously ruled, in the absence of a written record of judicial approval, "some present affirmative expression of a distinct recollection by Judge Brown" could be sufficient. 766 F.Supp. at 998. The testimony of Judge Brown, as corroborated by the testimony of the other witnesses, is sufficient to establish that Judge Brown did approve of the stock option plan.

The option exercised by plaintiff Robert Brooks in 1980 was a "qualified stock option" within the meaning of § 422 of the Internal Revenue Code of 1954.

IT IS BY THE COURT THEREFORE ORDERED that judgment be entered in favor of plaintiffs.

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF KANSAS

ROBERT A. BROOKS and CAROL M. BROOKS,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

CIVIL ACTION No. 88-1493-T.

October 30, 1991

Donald W. Bostwick, Adams, Jones, Robinson & Malone, Wichita, Kan., for plaintiffs.

Annette B. Gurney, U.S. Attorney's Office, Wichita, Kan., for defendant.

MEMORANDUM AND ORDER

THEIS, District Judge.

This matter is before the court on plaintiffs' motion to alter or amend or reconsider judgment. The underlying facts of this tax refund case are set forth in a published order in which the court granted summary judgment in favor of

defendant. Doc. 30, Order of June 5, 1991, *published at* 766 F.Supp. 993 (D.Kan.). Subsequently, plaintiffs filed the present motion in which plaintiffs made the alternative request to conduct further discovery pursuant to Fed.R.CiP. 27(b). The court allowed plaintiffs to take an additional deposition and deferred ruling on the motion pending taking of the deposition and reargument. Order of July 12, 1991, Doc. 37. The court has considered the additional evidence and the parties' arguments and is now prepared to rule on plaintiffs' motion.

The only issue remaining is whether the Hon. Wesley E. Brown, acting in lieu of the stockholders of the Clinton Oil Company ("Clinton"), approved a 1974 stock option plan that had been adopted by Clinton's board of directors. If so, plaintiffs are entitled to the favorable tax treatment available for those stock option plans that are "qualified" as defined under 26 U.S.C. § 422(b)(1). In its June 5, 1991 order, the court ruled that plaintiffs could demonstrate Judge Brown's alleged approval of the stock option plan either by producing some written record of the approval or "by some present affirmative expression of a distinct recollection by Judge Brown." 766 F.Supp. at 998. Plaintiffs have been unable to produce any evidence of a written record of approval. Thus, the court considers whether plaintiffs have now produced sufficient evidence to create an issue of fact regarding the alleged oral approval by Judge Brown.

The court has reviewed Judge Brown's deposition testimony taken pursuant to the July 12, 1991 order. The

cross examination by the government contains the following exchange:

> Q. Your Honor, do you have any recollection of reviewing the employee stock option plan?
>
> A. No.
>
> Q. Do you have any present recollection of the meeting referred to in the affidavits of March 20th, 1974 in your chambers with Mr. Volk, Mr. Martin and Mr. Woods?[1]
>
> A. Only, I have no recollection of such a meeting, as such on that date. I have a recollection of meetings but to pick out one meeting and say do I recall that particular meeting, I have none. They were in and out too often and I was getting rid of them. I kept telling them that I wasn't running this company, they were.
>
> Q. Did you ever or do you have a present recollection of making an oral order with respect to the employee stock option plan?
>
> A. No.

Doc. 38, Attachment, at p. 26.

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[1] This question refers to the affidavits of Clinton's Chairman of the Board, its President, and an attorney for Clinton during the SEC litigation. *See* 766 F.Supp. at 997.

This exchange demonstrates that Judge Brown does not specifically recall the approval of the stock option plan on a certain date. The testimony of Judge Brown reveals that he remembers nothing specific on the subject stock option plan other than his denial of the stock option offering to the board of directors. The testimony of Judge Brown does, however, reveal a general recollection that he may have orally approved the stock option plan in an informal session in his chambers.

The evidence supporting plaintiffs' position is the general practice from which plaintiffs make the inference of approval. Judge Brown refers to a general practice under which the Clinton parties would call on him in chambers and report the proposed action to him. Judge Brown explained:

> I think they would come in and ask me what I thought on it and if there was any conflict or any disposition they would tell me that they reported it to the Securities Exchange Commission and I would say, "If there is no conflict, I have no objection to it." Or if it came up with something that I had some feeling in the manner of a suggestion but not to take away the authority of the board.

Doc. 38, Attachment, at p. 21. Upon being informed that no written record or order of his alleged approval existed, Judge Brown stated:

> Well, I guess that the board of directors that I said I didn't want them in there, that I would not approve it if they brought it to me. Otherwise I'm sure that I approved it but I have no recollection of the kind of approval except that it was not to go to the board of directors and that, my approval would have been very frankly if the board of directors thinks this is a good business judgment, I have nothing to, no reason not to approve it.

Id. at p. 25 (emphasis added). The approval to which Judge Brown refers is an inference from a general practice.

Other evidence in this case circumstantially corroborates Judge Brown's general recollection that he did approve of a stock option for Clinton's officers but not directors. The record discloses an employment contract dated May 21, 1973 between Clinton and Richard W. Volk as President providing for a stock option. Doc. 24, Att. A, Exh. 19. Judge Brown's order of May 29, 1973 approved the contract including the stock option. Doc. 24, Att. A, Exh. 20. The SEC also approved Volk's contract including the stock option. Doc. 24, Att. A, Exh. 20. This formal written approval by Judge Brown of Volk's stock option indicates that a similar plan for other officers would also be approved. The Volk employment contract anticipated future stock option plans. Doc. 24, Att. A., Exh. 19, para. 8.

In the same general time frame, minutes from a board of directors meeting disclose formal approval of a stock option plan for officers, with no stock option provision for

directors. Doc. 21, Exh. D. This is in conformity with Judge Brown's distinct recollection of his disapproval of the stock option for directors.

The court is convinced from a reading of Judge Brown's deposition as a whole and the other corroborating evidence that a fact question is presented as to whether Judge Brown, acting in the stead of the stockholders, approved the stock option plan. Based on the totality of the evidence--the affidavits by affiants who appear to have no interest in this matter and Judge Brown's general affirmation that he probably gave oral approval to the stock option plan--the court finds that there is a genuine fact issue precluding summary judgment. The final determination will depend on the credibility of the witnesses, which is a matter that cannot be resolved on a motion for summary judgment.

It is regrettable that such an important transaction was not memorialized by a formal written order. Such a written order would have avoided the legal and factual issues before the court. However, judges often do make oral orders and decisions which are binding on the parties. The court prefers truth over form or procedure. The court believes that the shareholder protection envisioned by the drafters of 26 U.S.C. § 422(b)(1) would be furthered by allowing Judge Brown's approval to substitute as the proxy for the shareholders' voice in stock option offerings to the corporation employees. The purpose of the statute and regulation is furthered by the interpretation made here by the court.

The court shall therefore grant the motion to reconsider and shall deny all motions for summary judgment. The evidence from Judge Brown's deposition and the affidavits show a genuine factual issue on approval of the stock option plan for plaintiff.

IT IS BY THE COURT THEREFORE ORDERED that plaintiffs' motion to alter or amend judgment or for reconsideration (Doc. 33) be granted. The defendant's motion for summary judgment (Doc. 21) is hereby denied. The plaintiffs' motion for summary judgment (Doc. 24) is hereby denied.

The court shall hold a status conference on December 3, 1991 at 2:00 p.m.

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF KANSAS

ROBERT A. BROOKS and CAROL M. BROOKS,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

CIVIL ACTION No. 88-1493-T.

June 5, 1991

Donald W. Bostwick, Adams, Jones, Robinson & Malone, Wichita, Kan., for plaintiffs.

Annette B. Gurney, U.S. Atty's Office, Wichita, Kan., for defendant.

MEMORANDUM AND ORDER

THEIS, District Judge.

This matter is before the court on cross motions for summary judgment.* The action is brought for the refund of taxes paid for the 1980 tax year. Jurisdiction lies in this court under 28 U.S.C. § 1346(a)(1).

I. Background

Plaintiff Robert E. Brooks was an employee of Energy Reserves Group, Inc. ("Energy Reserves") from 1977 until 1986. Energy Reserves was formerly known as Clinton Oil Company ("Clinton"). In connection with his employment, plaintiff was offered a stock option plan to purchase 60,000 shares of stock, which option was exercised on June 17, 1980.

The ultimate issue presented is whether the option exercised by plaintiff in 1980 was a "qualified stock option" within the meaning of § 422 of the Internal Revenue Code of 1954. If so, the taxpayer need not recognize income at the time the option is exercised. If not, the taxpayer must recognize the gain received from the exercise of his option. The statute provides:

> For purposes of this part, the term "qualified stock option" means an option granted to an individual ... for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or

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* The court does not believe that oral argument would be useful in this case, and therefore denies plaintiffs' request. D.Kan.Rule 206(d).

> subsidiary corporation, to purchase stock of any of such corporations, but only if--
>
> (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under option, and the employees ... eligible to receive options, *and which is approved by the stockholders of the granting corporation* within 12 months before or after the date such plan is adopted; ....

26 U.S.C. § 422(b)(1) (emphasis added). The Treasury Regulation implementing this statute provides:

> A qualified stock option granted after December 31, 1964, must be granted pursuant to a plan *which is approved by the stockholders of the granting corporation* within 12 months before or after the date the plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting.

26 C.F.R. § 1.422-2(b)(1) (emphasis added).

II. Uncontroverted Facts

The material facts set forth below are uncontroverted unless otherwise noted.

1. On January 15, 1973, the Securities and Exchange Commission ("SEC") filed an injunction action in this court against Clinton, the predecessor of Energy Reserves. [hereinafter *SEC v. Clinton*].

2. Presiding over the injunction action was the Hon. Wesley E. Brown.

3. On February 1, 1973, the Joint Shareholders Protective Committee of Clinton ("the Committee") filed a motion to intervene in *SEC v. Clinton*. Attached to this motion was the proposed complaint of the Committee requesting, among other relief, an order directing Clinton to allow inspection of its stock ledger and stockholder list, and to have the list filed with the court; and an order directing Clinton to notice and convene a meeting of its stockholders under the supervision of the court so that the stockholders could express their views, elect directors, and deal with all other appropriate matters.

4. By order filed February 27, 1973, Judge Brown found the application to intervene premature, and therefore held the application in abeyance. Judge Brown also denied the application of the Committee to inspect Clinton's stock ledger.

5. On March 8, 1973, Judge Brown approved a settlement entered into by the parties of *SEC v. Clinton.* According to this settlement, Judge Brown assumed certain duties and responsibilities in connection with Clinton's reorganization.

6. On March 9, 1973, Judge Brown entered an order appointing special counsel for Clinton to take such action and exercise such authority as set forth in the March 8 order approving settlement.

7. On March 16, 1973, Judge Brown entered order designating and approving certain individuals to serve as directors of Clinton to "serve subject to the continuing jurisdiction of the court with respect to all matters relating to the implementation, accomplishment, and enforcement of the acts to be done pursuant to the Memorandum of Understanding of Terms of Settlement and the order of the court entered thereon."

8. On May 11, 1973, Judge Brown entered an order establishing the fees to be paid to the directors for their services.

9. On June 4, 1973, Judge Brown entered an order appointing a certified public accounting firm to conduct the accounting and make the report required by his prior order of March 8, 1973.

10. On May 29, 1973, and with consent of the SEC, Judge Brown entered an order approving and appointing Richard W. Volk as President and Chief Executive Officer of

Clinton, and approving a written agreement of employment between Volk and Clinton that had been approved by Clinton's Board of directors.

11. On March 18, 1974, the directors of Clinton adopted the Clinton Oil Company 1974 stock option plan that is at the heart of this dispute. It is disputed whether Judge Brown approved this Plan.

12. The last meeting of the shareholders before March 18, 1974 was on June 3, 1971. The first meeting of the shareholders following March 18, 1974 was on July 14, 1976. Thus, the March 18, 1974 stock option plan was not approved by a majority of the shareholders within 12 months either before or after the directors approved the plan.

13. On July 2, 1976, and on the motion of Energy Reserves (formerly Clinton), Judge Brown entered an order that approved the holding of an annual meeting of the stockholders of Energy Reserves to he held on July 14, 1976, and that established the procedure for examination of the list of stockholders of Energy Reserves.

14. By orders filed July 27, 1976, Judge Brown terminated the appointment of special counsel for Clinton, and terminated the court's jurisdiction and supervision as assumed by the court on March 8, 1973.

15. On June 17, 1980, plaintiff exercised his option as offered in the 1974 stock option plan. The fair market value of the stock at that time exceeded the exercise price of the option by $603,750.00, which was treated by the Internal

Revenue Commission as a gain. As a result of and directly attributable to this gain, plaintiffs paid $210,253.00 for the 1980 tax year.

III. Discussion

The parties agree that the specific issues presented are: (1) whether Judge Brown had "stockholder" authority within the meaning of 26 U.S.C. § 422(b)(1) to approve the 1974 stock option plan; and (2) if so, whether Judge in fact exercised this authority.

The court must begin its analysis with the statutory language. *Mallard v. United States Dist. Court for the Southern Dist. of Iowa,* 490 U.S. 296, 109 S.Ct. 1814, 1818, 104 L.Ed.2d 318 (1989). The plain meaning of the legislation is conclusive unless "'the literal application of a statute would produce a result demonstrably at odds with the intention of its drafters.'" *United States v. Ron Pair Enters., Inc.,* 489 U.S. 235, 109 S.Ct. 1026, 1030, 103 L.Ed.2d 290 (1989) (quoting *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 571, 102 S.Ct. 3245, 3250, 73 L.Ed.2d 973 (1982)). Thus, in determining the meaning of a statute, the court must "look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy." *Crandon v. United States*, 494 U.S. 152, 110 S.Ct. 997, 1001, 108 L.Ed.2d 132 (1990).

In addition, a court passing on an agency's interpretation of the statute it administers must adhere to the analysis prescribed by *Chevron U.S.A. Inc. v. Natural*

Resources Defense Council, Inc., 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984):

> First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based upon a permissible construction of the statute.

Id. at 842-43, 104 S.Ct. at 2781-82. *See also INS v. Cardoza-Fonseca,* 480 U.S. 421, 446-48, 107 S.Ct. 1207, 1221-22, 94 L.Ed.2d 434 (1987); *Pension Benefit Guaranty Corp. v. LTV Corp.*, ___ U.S. ___, 110 S.Ct. 2668, 2676-77, 110 L.Ed.2d 579 (1990).

The language of § 422(b)(1) refers only to stockholder approval as a necessary predicate to qualify a stock option for tax purposes. Nonetheless, plaintiff argues that the unique circumstances of this case permit Judge Brown's approval of the stock option plan to substitute as the functional equivalent of the statutory requirement of stockholder approval. This

result, it is argued, is consistent with the underlying purpose of the statute.

The legislative history of § 422 reveals that the purpose of granting favorable tax treatment to qualified options was to allow corporations to offer an employment incentive to certain employees. *See* H.R.Rep. No. 749, 88th Cong., 1st Sess. 64 (1963). Congress was also concerned, however, that company executives could make excessive use of stock option offerings to the detriment of the stockholders' interests. *Id.* at 65. Thus, the requirement of stockholder approval was imposed to ensure the stockholders a voice in the use of stock options. *Id.*

Because the stockholders were prevented from voting on the 1974 stock option plan within the 24-month window of § 422, and because Judge Brown was representing the interests of stockholders during this time, plaintiffs argue that Judge Brown could properly serve as the stockholders' proxy in approving the stock option plan. Defendant does not dispute that the purpose of stockholder approval under § 422 was to protect the stockholders from excessively generous perquisites offered to the corporation's management. Rather, defendant contends that regardless of the adequacy of Judge Brown's supervision, § 422(b)(1) requires observance of all the formalities of corporate democracy before an employee may enjoy favorable tax treatment of income realized from the employee's exercise of a corporation-offered stock option. Defendant contends that its regulations and rulings have consistently reflected this view.

Although the statute is silent as to the procedure by which stockholder approval must be obtained, Treas.Reg. § 1.422-2(b)(1) requires that such approval comply with state law and "all applicable provisions of the corporate charter and bylaws," and further requires "the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting." The Service has interpreted this regulation to require both the "express consent of the stockholders who hold at least a majority of the outstanding voting stock *and* vote in person or by proxy at a duly held stockholders' meeting." Rev.Rul. 75-256, 1975-2 C.B. 194 (emphasis in original). In addition, the Service has recognized only one narrow exception to the requirement of express majority consent at a stockholders' meeting. If a stockholders' meeting is not convened, the Service has allowed the *unanimous* written consent of the stockholders to substitute for the procedure set forth in Treas.Reg. § 1.422-2(b)(1). In Rev.Rul. 80-29, 1980-1 C.B. 93, the Service explained that the purpose of unanimous consent in the absence of a stockholders' meeting is to allow dissenting stockholders an opportunity to persuade other stockholders. If, however, there are no dissenters, there is no need to require approval at a stockholders' meeting. *Id.* In reliance on this authority, the Service argues that the statute was intended not merely as one means by which the interests of the stockholders could be protected, but as the only means.

A question similar to that presented here was addressed by the Court in *City Bank Farmers Trust Co. v. McGowan*, 323 U.S. 594, 65 S.Ct. 496, 89 L.Ed. 483 (1945). In *McGowan*, the Court considered whether a New York district

court, acting on behalf of an incompetent person, could make a donative transfer "in contemplation of death" within the meaning of § 302(c) of the Revenue Act of 1926. The government took the position that the state court, which had parens patriae authority to grant allowances out of the income of an incompetent, could also make these allowances in "contemplation of death," and that the transfers granted by the state court were therefore includable in the gross taxable estate of a decedent. The Court agreed:

> Literally [the decedent] neither made the transfers nor did she have any motive with respect to them. But a court stood in her place and unquestionably had the function of effectuating a transfer of her property and of determining what motive or purpose would have actuated her had she been competent to act. It seems to us that it is sticking in the bark to say that, in the circumstances, the transfers are not within the section because Congress did not add a phrase to the effect that where a court made the transfer, acting in lieu of the incompetent owner, such a transfer should be governed by the statute.

McGowan, 323 U.S. at 598-99, 65 S.Ct. at 498.

As in *McGowan*, this court is asked to sacrifice the legislative intent to a literal interpretation of a statute. This the court declines. Congress is neither required nor able to foresee every contingency when it drafts legislation. It is undisputed that Judge Brown had, and in fact exercised, extraordinary powers in conducting the corporation's

affairs--powers normally reserved to the directors and stockholders of a corporation. It is likewise conceded that Judge Brown represented the interests of the shareholders in his oversight of the corporation. Doc. 22, at 13. Under defendant's interpretation, even the most vigilant representation of the shareholders' interests may not substitute for the shareholders' actual votes at a shareholders' meeting. But as applied to the unique facts of this case, defendant's interpretation operates to defeat the conceded central purpose of the statute. By denying plaintiffs the tax benefit of the stock option plan, defendant would deprive the corporation of the very employment incentive that Congress intended to grant corporations. Moreover, defendant places this interpretation on the statute under circumstances when the corporation was in most need of being able to offer the statutory incentive to prospective competent officers. When Judge Brown exercised authority normally reserved to the stockholders, he acted as the unanimous voice of the stockholders. A contrary conclusion is inconsistent with the intent of Congress--an intent that the Service is not at liberty to ignore.

The court concludes that Judge Brown had the authority to exercise stockholder approval within the meaning of § 422(b)(1). It is therefore necessary to consider whether he in fact did approve the stock option plan.

The court is presented with no evidence of a written order by Judge Brown approving the 1974 stock option plan. Nor is there any transcript of any proceeding in which Judge Brown approved the plan. Instead, plaintiffs direct the court's attention to the affidavits and deposition testimony of

Robert Martin, an attorney for Clinton in *SEC v. Clinton,* the affidavit of Paul Woods, former Chairman of the Board of Clinton, and the deposition testimony of Richard Volk, the president of Clinton as of May 1973. These three individuals state that they were present at a meeting in Judge Brown's chambers in March 1974 during which meeting Judge Brown approved the stock option plan already adopted by Clinton's board of directors. Plaintiffs have not deposed Judge Brown regarding his recollection of this meeting.

Plaintiffs contend that although no written record exists of Judge Brown's approval of the stock option plan, oral testimony of the persons attending the March 1974 meeting is sufficient to establish the fact of his approval. Plaintiffs also submit that the court should require defendant to produce any evidence that would controvert Judge Brown's approval of the plan. This misconstrues the burden of proof in this case. It is well established that in tax refund cases, the taxpayer bears the burden of proving error in both the assessment and amount of the deficiency claimed by the government. *United States v. Janis,* 428 U.S. 433, 440, 96 S.Ct. 3021, 3025, 49 L.Ed.2d 1046 (1976); *Doyal v. Commissioner,* 616 F.2d 1191, 1192 (10th Cir.1980); *Central Motor Co. v. United States,* 583 F.2d 470, 476 (10th Cir.1980); *Brown v. United States,* 890 F.2d 1329, 1334 (5th Cir.1989). Thus, unless plaintiffs are able to demonstrate a genuine issue regarding whether Judge Brown approved the plan, summary judgment in favor of defendant is dictated. *See Celotex Corp. v. Catrett,* 477 U.S. 317, 322, 106 S.St. 2548, 2552, 91 L.Ed.2d 265 (1986).

It has often been said that courts speak only through their orders of record or journal entries. *See United States v. Martin*, 913 F.2d 1172, 1175 (6th Cir.1990) (citing cases); *Schmidt v. Esquire, Inc.*, 210 F.2d 908, 914 (7th Cir.), *cert. denied*, 348 U.S. 819, 75 S.Ct. 31, 99 L.Ed. 646 (1954); *Kostyu v. United States*, 742 F.Supp. 413, 416 n. 2 (E.D.Mich.1990); *Cedar Crest Health Center, Inc. v. Bowen*, 129 F.R.D. 519, 524 (S.D.Ind.1989); *Coe v. Ziegler*, 657 F.Supp. 182, 187 (S.D.Ohio 1987); *Tate v. International Business Machs. Corp.*, 94 F.R.D. 324 (N.D.Ga.1982). It is not necessary, however, to determine whether this statement applies to every context in which the legal force of an oral, unrecorded order of the court might be called into question. For present purposes, the only question is whether Judge Brown could orally approve the 1974 stock option plan within the meaning of § 422, and if so, what evidence is sufficient proof of such approval. In resolving this matter, the court must be mindful of the protective purpose of the statutory requirement of stockholder approval.

Plaintiffs argue that nothing in the Federal Rules of Evidence precludes consideration of matters dehors the record for the purpose of proving judicial approval of the plan. *Cf. Allen v. W.H.O. Alfalfa Milling Co.*, 272 F.2d 98, 100 (10th Cir.1959) (testimony is inadmissible where an Act of Congress requires proof by specific records). Plaintiffs further contend that if anything, the Federal Rules allow consideration of such evidence. *See* Fed.R.Evid. 102 (rules to be construed so that truth may be ascertained); *Id.* 402 (all relevant evidence admissible); *Id.* 601, 602 (every person competent to be a witness as to matters within personal knowledge).

The court believes that a level of protection within the contemplation of Congress would be afforded either by a written record of judicial approval or by some present affirmative expression of a distinct recollection by Judge Brown. Plaintiffs have presented the court with no evidence of either a written record or of deposition or affidavit statements by Judge Brown that he recalls, with sufficient clarity, the alleged approval of the plan. Thus, there is an inadequate basis for concluding that the stockholders' interests were in fact independently represented. Plaintiffs have failed to demonstrate a genuine issue of this material fact on which they bear the burden of proof, and summary judgment in defendant's favor is therefore appropriate.

IT IS BY THE COURT THEREFORE ORDERED that defendant's motion for summary judgment (Doc. 21) be granted.

IT IS FURTHER ORDERED that plaintiff's motion for summary judgment (Doc. 24) be denied.

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 92-3295
D.C. No. 88-149

ROBERT A. BROOKS and CAROL M. BROOKS,

Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

ORDER
Entered October 3, 1994

Before SEYMOUR, Chief Judge, MOORE, ANDERSON, TACHA, BALDOCK, BRORBY, EBEL, KELLY, HENRY, SETH, BARRETT and LOGAN, Circuit Judges.

This matter comes on for consideration of appellees' petition for rehearing and suggestion for rehearing in banc.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision.

In accordance with Rule 35(b), Federal Rules of Appellate Procedure, the suggestion for rehearing in banc was transmitted to all of the judges of the court who are in regular active service. No member of the panel and no judge in regular active service on the court having requested that the court be polled on rehearing in banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing in banc is denied.

Entered for the Court

PATRICK FISHER, Chief Deputy Clerk

By /s/ L. Balzano
Deputy Clerk